

auditor to purchase or license products from an audit client “as a consumer in the normal course of business.” (EY Brief at 3.) EY maintains that EY/GEMS for PeopleSoft is not a combination or packaging of EY and PeopleSoft products; rather, EY simply used PeopleTools. EY argues that even if EY/GEMS for PeopleSoft were a combination, the rules do not prohibit a bundling of fragments of EY and PeopleSoft products. Finally, EY argues that the Licensing Agreement specifies that it does not create a joint venture or joint ownership, and the royalty provisions do not change the intent of the parties. (EY Brief at 11-27.)

EY’s experts, Dr. Hitt and Mr. Mooney, represent that licensing PeopleTools was a normal business practice for PeopleSoft and cite technology practices in “today’s world,” but they do not cite any situation where an auditor licensed development software from its audit client. (EY Exs. 1310 at 11-12, 1311 at 11-12.) In addition, Dr. Hitt stressed that the Licensing Agreement provisions were standard in the software industry, and that persons familiar with the industry knew that EY/GEMS for PeopleSoft was not a joint product, and the persons “with a modest understanding of the software industry” would not conclude that partnering and alliance endeavors indicated a legal partnership or joint development or marketing effort. (EY Ex. 1310 at 12-20.)

However, the standard in assessing independence is not the perception of a specialized group of people. Rather, the standard is whether EY and PeopleSoft shared a mutual interest in the success of EY/GEMS for PeopleSoft and acted together to promote the product so that a reasonable investor with knowledge of all the facts would conclude that EY was closely identified in fact and appearance with its audit client. (Div. Ex. 748 at 9-10 (citing Codification Section 602.02.g).) Moreover, at least two people at PeopleSoft with industry experience were concerned due to EY’s status as PeopleSoft’s auditor. Ms. Gonzalez voiced concerns to her supervisor and Mr. Horne believed that the revenue sharing arrangement violated EY’s Guidelines on auditor independence. (March 24, 2003, Tr. 18-19, March 31, 2003, Tr. 158-59.)

Finding

The Licensing Agreement between EY and PeopleSoft created a direct business relationship. The following provisions of the Licensing Agreement created an identity or mutuality of interest between EY and PeopleSoft: (1) EY’s payment of royalties of the greater of a base of \$300,000 or actual royalties on product sales or renewals; (2) PeopleSoft’s agreement to provide EY with technical support to assist product development; (3) PeopleSoft’s right of final approval over release of EY/GEMS for PeopleSoft and how it was priced; (4) PeopleSoft’s right to approve marketing materials prepared by EY; (5) the right of EY to use PeopleSoft’s trademark to market materials; and (6) the requirement that EY obtain signed sublicense agreements from each end-user of EY/GEMS for PeopleSoft prior to delivery of the product. (Div. Exs. 121.) The terms of the Licensing Agreement created a situation where the success of EY/GEMS for PeopleSoft was in the best interests of both EY and PeopleSoft. The greater the sales of EY/GEMS for PeopleSoft, the higher the royalties that EY paid to PeopleSoft.⁴⁴ Certain

⁴⁴ There is no indication that the computer processing situation described in the Codification, which EY claims is analogous, involved an agreement for royalties or any of the other features

provisions of the Licensing Agreement considered separately, such as the royalty provisions, EY's use of the PeopleSoft logo and trademark for marketing purposes, and PeopleSoft's right to approve the final product and give input on the product price individually, support a joint business venture finding. Considering the totality of the Licensing Agreement, the evidence is overwhelming that EY/GEMS was a joint product. (Div. Ex. 121.)

The evidence is persuasive that EY/GEMS for PeopleSoft was much more than a bundling of fragments and that EY did more than use PeopleTools for development purposes. Standing alone, EY/GEMS for PeopleSoft provides significant indicia that cause it to be considered a joint business venture. (March 24, 2003, Tr. 108.) "[W]e approached PeopleSoft with the idea of developing a version of EY/GEMS in their development tool which would be completely integrated with their HRMS. The solution was beneficial for both sides as mutual clients would have the integrated system with the same look and feel for data entry and processing, as well as real-time data access." (Div. Ex. 126 at 031933.) EY/GEMS for PeopleSoft is the result of putting together EY's proprietary EY/GEMS software and PeopleSoft's proprietary product, HRMS using PeopleTools into a single integrated system. (March 21, 2003, Tr. 245; Div. Ex. 127 at 031943-44.) Persons acquiring EY/GEMS for PeopleSoft received material that listed the program's functions and identified those that were part of PeopleSoft. (Div. Exs. 412 at 036201-2, 531 at 040778-79.) The use of PeopleTools to create screens always involves the use of PeopleSoft's proprietary language PeopleCode. (March 24, 2003, Tr. 120-21, 144-46.) Pursuant to the Licensing Agreement, PeopleTools was incorporated into EY/GEMS for PeopleSoft and distributed to end-users. (Div. Ex. 121 at ¶ 2-b.) EY already had access to PeopleTools as part of its PeopleSoft HRMS license and as an implementation consultant, but it needed an additional license to distribute PeopleTools as part of EY/GEMS for PeopleSoft. (March 28, 2003, Tr. 82.)

The EY/GEMS for PeopleSoft developers succeeded in producing a product that would "share common functionality and databases and adhere to the standards of the PeopleSoft application." (Div. Ex. 591.) In application, "the user would only have to log on to one application to be able to access both the PeopleSoft delivered screens and the EY/GEMS screens." (March 24, 2003, Tr. 171.) The log-on was accomplished through PeopleSoft HRMS. (EY Brief at 14.) The screen would show the standard PeopleSoft tool bars, menu items, and functionality. A double-click on the PeopleSoft icon would bring up EY/GEMS for PeopleSoft as a menu option.⁴⁵ (March 24, 2003, Tr. 143-62, 168-71; Div. Ex. 618 at 043632.)

The intellectual assets of EY and PeopleSoft are the integral components of the product EY/GEMS for PeopleSoft. Knowledgeable people described EY/GEMS for PeopleSoft in terms that reasonable people would interpret as indicating a joint business venture or joint product. An EY partner characterized EY/GEMS for PeopleSoft as an effort "to port the EY/GEMS product to the PeopleSoft platform." (Div. Ex. 198 at 032364.) The result was that EY's GEMS

contained in the Licensing Agreement. The factual situation set out in the Codification does not describe the agreement for services. Codification, Section 602.02.g, Example 1.

⁴⁵ A user also has to click "OK" to verify data base type and sign-on. Once in PeopleSoft, the user would click "Start" and see the menu options, one of which is "EY/GEMS for PeopleSoft." (Div. Ex. 618 at 043632.)

application interfaced seamlessly with PeopleSoft's HRMS/Payroll product. (March 21, 2003, Tr. 126; Div. Ex. 652 at 043792.) Dr. Hitt described EY/GEMS for PeopleSoft as "a software application that complemented the capability of the PeopleSoft Human Resources Management System (HRMS) to enable end users, typically corporate human resource professionals, to perform a variety of tax calculations, compensations calculations, and recordkeeping activities relating to expatriate employees." (EY Ex. 1310 at 2.) Ms. Gonzalez considered that "it was made with PeopleTools so that made it kind of [a] joint product." (March 24, 2003, Tr. 108.)

EY and PeopleSoft viewed EY/GEMS as mutually beneficial. (March 24, 2003, Tr. 15, 22-29, 64-65.) EY projected that "[a]s PeopleSoft expands its sales both in the U.S. and globally, the demand for EY/GEMS functionality to be integrated into its HRMS product will only increase." (Div. Ex. 641 at 043755.) PeopleSoft explained in a 1999 publication that:

[f]or clients using PeopleSoft HRMS/Payroll, the integration of [EY/GEMS] functionality provides a total solution for international companies. . . .

The database consists of four core administrative and planning modules and several supplemental modules, which all interface to minimize data entry and create a system that addresses pertinent expatriate management needs. Because the system is integrated into PeopleSoft HRMS, clients also receive the benefits of:

A single integrated system, thus eliminating duplicate processes and procedures.

The same flexibility as PeopleSoft for customization of panels and code.

EY/GEMS upgrades simultaneous with PeopleSoft upgrades.

The full spectrum of EY/GEMS tools needed to get the job done.

(Div. Ex. 304 at 034917.)

EY argues that the terms of the Licensing Agreement do not create a joint business venture because, among other things, the payment of royalty fees was standard in the software industry. (EY Brief at 22-27.) EY's argument is unpersuasive. As PeopleSoft's auditor, EY had to abide by the independence rules regardless of what others in the industry were doing. In addition, EY's defense that EY/GEMS for PeopleSoft was a software product developed and marketed by EY alone is not true. EY paid \$75,000 to PeopleSoft for technical assistance and admits that PeopleSoft provided technical assistance on "rare occasions." (EY Ex. 1311 at 14.) The evidence is that EY marketed EY/GEMS for PeopleSoft as a joint product, and that it did so at PeopleSoft User Conferences. At PeopleSoft's 1999 User Conference, Michael Fischer from EY's Tax practice insisted that PeopleSoft announce that EY/GEMS for PeopleSoft was PeopleSoft's preferred solution for computing expatriate payroll and tax data. (March 24, 2003, Tr. 91-92.)

In its promotional literature, EY described EY/GEMS for PeopleSoft as a joint product. "We have developed jointly with PeopleSoft, EY/GEMS, a global expatriate tax system

integrated with PeopleSoft Payroll.” (Div. Ex. 243 at 33119.) In a 1999 sales presentation, EY described “JOINT PRODUCTS – EY/GEMS for Human Resources.” (Div. Ex. 299H at 034807.) In another sales presentation, EY in discussing its “Lengthy, Close Working Relationship” with PeopleSoft repeated, “We have developed jointly with PeopleSoft, EY/GEMS, a global expatriate tax system integrated with PeopleSoft Payroll.” (Div. Ex. 513 at 039944.) An EY brochure bearing the logos of both EY and PeopleSoft titled “EY/GEMS™ + PeopleSoft tm = EY/GEMS for PeopleSoft” explained that:

PeopleSoft is the worldwide leader in relational client/server HRMS/payroll packaged software. For more than twenty-five years [EY] has been the worldwide leader in providing expatriate services. EY/GEMS for PeopleSoft brings together the experience of these two leaders

EY/GEMS for PeopleSoft is a single integrated system

(Div. Ex. 127 at 031943-44; March 21, 2003, Tr. 241-45.) EY’s advertising materials for EY/GEMS for PeopleSoft featured the PeopleSoft logo. (March 21, 2003, Tr. 241-47; Div. Exs. 127, 625.) Mr. Bishko did not seek advice from either Mr. Coulson or anyone at EY on whether EY marketing materials bearing the EY and PeopleSoft logos violated the independence rules.⁴⁶ (March 21, 2003, Tr. 245.)

The major accounting firms, including EY’s predecessor, acknowledged in a petition, which resulted in the Commission’s 1989 Response, that “while an accountant may provide non-attest services for an audit client’s own use, the provision of such services is forbidden if the client intends to combine the services with its own and sell the entire package to a third party.” (Div. Ex. 127 at 031946.) This prohibition, which EY recognized in 1988, applies to EY/GEMS for PeopleSoft, a combination of auditor and client products in a single package.

EY activities in marketing EY/GEMS for PeopleSoft provide additional indicia that EY promoted the product based on its mutuality or identity of interests with PeopleSoft. A January 24, 1995, EY press release announced that:

EY/GEMS for PeopleSoft delivers a seamless interface that provides the same functionality for information systems (IS) professionals maintaining the system and HR professionals utilizing the reporting and recordkeeping functionalities, regardless of their location. PeopleSoft provides the development toolset that enables Ernst & Young to build a client/server Windows-based application of EY/GEMS. . . . EY/GEMS will seamlessly interface with PeopleSoft’s current international assignment module, expanding on the tracking of employee home and host data, defining assignment details, tracking employee residence, visa and work permit requirements, and adding the compensation and tax functionality needed by HR professionals.

⁴⁶ Mr. Bishko supplied PeopleSoft with a hard copy of the EY logo in 1995. (Div. Ex. 600 at 043581.)

“We’re excited about EY/GEMS adding this important global dimension to PeopleSoft’s premier line of human resources applications,” said Michael J. Bishko, National Director of Expatriate Services for Ernst & Young.

(Div. Ex. 122 at 031905.) A news report in January 1995 stated that EY had “teamed up” with PeopleSoft “to develop a new software package it [hoped would] dominate the market for global work force management systems.” The same press report quoted Jay Levine, an EY partner and director of Expatriate Technology, Technology Services Group, as stating that EY viewed expatriate services as an emerging market since 600 of the top 1,000 United States companies had large international work forces. (Div. Exs. 123, 242.) A similar article appeared in Software Magazine in March 1995. (Div. Ex. 242.)

When EY released EY/GEMS for PeopleSoft in January 1996, it announced that it combined PeopleSoft’s human relations software with EY’s tax expertise for tracking and calculating expatriate employees’ costs and taxes.⁴⁷ The software was completely integrated into an installed PeopleSoft HRMS Payroll product and provided a seamless interface with other PeopleSoft panels and menu applications. (Div. Ex. 238A at 032768.) EY marketing materials declared:

PeopleSoft is the worldwide leader in relational client/server HRMS/payroll packaged software. For more than twenty-five years [EY] has been the worldwide leader in providing expatriate services. EY/GEMS for PeopleSoft brings together the experience of these two leaders to enhance your ability to support your company’s international agenda, your management and your expatriate employees. It creates a win-win equation for you and your organization.

(Div. Ex. 127 at 031944.) EY demonstrated the 6.0 version release of EY/GEMS for PeopleSoft at the 1997 PeopleSoft User Conference attended by over 10,000 people. (Div. Ex. 641.) EY projected increased demand for “EY/GEMS functionality to be integrated into [PeopleSoft] HRMS product” as PeopleSoft sales expanded domestically and globally. (Id.) EY noted in a 1998 product description that it had created this version of GEMS as an “Application Development Partner with PeopleSoft.” (Div. Ex. 238C at 032793.)

The EY-PeopleSoft direct business relationship continued into 1999, when PeopleSoft considered how to address customer concerns regarding expatriate processing, and decided to continue its partnership with EY. (March 24, 2003, Tr. 15-25.) EY’s Mr. Fischer tried unsuccessfully to convince PeopleSoft to sell and service a more integrated form of EY/GEMS for PeopleSoft. PeopleSoft rejected that proposal, but agreed to declare that EY/GEMS for PeopleSoft was its “preferred solution” for computing expatriate payroll and tax data. (March 24, 2003, Tr. 57, 60-61.)

⁴⁷ An EY document, dated June 1999, represented that version 7.0 was in production in the U.S. since December 1997. (Div. Ex. 182 at 032248, 032252.)

I find that a reasonable investor who knew of EY and PeopleSoft's mutual interest in the business success of EY/GEMS for PeopleSoft would make an objective and pragmatic assessment that EY would not be objective in its audit of PeopleSoft. My ruling has considered Mr. Mooney's concerns that the appearance of lack of independence is an arbitrary and capricious type of standard, and his warning that if it is used, it must be applied pragmatically and sensibly. (April 8, 2003, Tr. 60-61, 67-70.)

I reject: (1) EY's characterization of its status as a PeopleSoft application partner and alliance member, and its teaming up with PeopleSoft as involving "inconsequential matters"; and (2) its reliance on a Gartner Group Report that stated, "[b]ecause PeopleSoft is an audit client of E&Y, that precludes close partnering opportunities available to other [implementation consultants]." (EY Ex. 1311 at 15.) The use of the terms "partner" and "alliance member" are not per se determinative, but based on the evidence, they do connote a significant relationship and status in the technological industry. (March 24, 2004, Tr. 19-20; Div. Ex. 454 at 037140.) The record establishes that EY and PeopleSoft acted as partners in the sense that they shared a business interest and they acted together in a variety of ways for their mutual benefit. Finally, nothing suggests that the Gartner Group Report was anything more than a statement of what the author believed to be the standard for auditor-client business relationships. Even if the Gartner Group knew all the facts and made a conclusion, the standard is a reasonable investor standard not the conclusion of an information technology market research firm.

For all these reasons, I find that EY's actions in connection with EY/GEMS established a direct business relationship in the form of a joint product. EY's direct business relationship with PeopleSoft relative to EY/GEMS for PeopleSoft violated the auditor independence requirements unless EY was acting as a consumer in the normal course of business. See Codification, Section 602.02.g.

Consumer in the Normal Course of Business

EY believes that the record supports its judgment that the consumer in the normal course of business exception covers EY/GEMS for PeopleSoft. (EY Brief at 27-28.) The Division asserts that EY bears the burden of proof as to the applicability of the exception to its situation because a party asserting an affirmative defense has the burden of establishing it by the necessary proof. In re Johnson Bros. Truckers Inc., 9 Fed. App. 156, 161-62 (4th Cir. 2001) (assertion of "ordinary course of business exception" under 11 U.S.C. § 547(c)(2) operates as an affirmative defense). The Division likens the "consumer in the ordinary course of business" exception to an issuer claiming a statutory exemption to the Section 5 registration requirements of the Securities Act. SEC v. Ralston Purina, 346 U.S. 119, 126 (1953) (an issuer claiming an exemption under Section 4 of the Securities Act carries the burden of showing that the exemption is met) (Div. Brief at 101-04, Reply Brief at 59 n.36.) EY disputes the Division's position, citing Steadman v. SEC, 450 U.S. 91, 102 (1981), and characterizes the Division's case law as distinguishable and "specious." (EY Brief at 28.)

Inasmuch as the purpose of the securities statutes and regulations is to protect investors, the burden of persuasion is with the person claiming an exemption from a Commission rule. Steadman places the burden on the Division to prove the allegations in the OIP; however,

Ralston Purina places the burden on a respondent if it claims that a rule of general applicability does not apply to its particular situation. 346 U.S. at 126. In any event, the evidence here is compelling, and the Division carried any burden that it may have had. (Div. Findings of Fact at 60-61; EY Brief at 28-29; Div. Reply Brief at 59 n.36.)

Dr. Carmichael and Mr. Rush reject EY's position that its relationship with PeopleSoft relative to EY/GEMS for PeopleSoft was as a consumer in the normal course of business because EY was not a consumer and the transaction was not in the normal course of business. (Div. Exs. 741 at 12, 748 at 12.) Dr. Carmichael cites Black's Law Dictionary to support his contention that EY is not a consumer because it did not use the PeopleSoft's product internally.⁴⁸ In support of their positions, Dr. Carmichael and Mr. Rush cite the Commission's 1989 Response where it rejected the accounting firms' position that prime or subcontractor relationships or other cooperative service arrangements between auditors and clients fell within the consumer in the normal course of business exception. (Div. Exs. 741 at 15, 748 at 12.) In his forty years of accounting experience, Mr. Rush has never known an accounting firm to pay royalties to an audit client. (Div. Ex. 748 at 13-14.) Mr. Rush concluded that the relationship was not in the normal course of business because, among other things: it was unusual for PeopleSoft to provide its proprietary language; it is not normal for an accounting firm to pay its suppliers royalties; an accounting firm does not normally give a supplier a third-party-beneficiary interest in its revenues; a CPA firm does not normally allow a supplier to give input on how it should price its services and products; and a CPA firm does not normally receive a large competitive advantage from an audit client. (Div. 748 at 13-14.)

Mr. Mooney believes that EY did not violate the independence rules because, in substance, the transaction was nothing more than an effort by EY to rewrite an existing software program. (EY Ex. 1311 at 9-10.) Mr. Mooney believes that EY entered into the Licensing Agreement as a consumer in the normal course of business. (EY Ex. 1311 at 11-14.) Dr. Hitt concluded that EY was a consumer of software development tools in the normal course of its business as a software developer, and that EY/GEMS for PeopleSoft was an EY product marketed by EY. (EY Ex. 1310 at 3.) Dr. Hitt opined that:

1. The Licensing Agreement's grant of the use of PeopleTools, the payment of royalties, EY's limited consultation with PeopleSoft technical support personnel, use of the terms "partner" or "alliance" member, and use of PeopleSoft in the product's name does not show that EY/GEMS for PeopleSoft was a joint product.
2. PeopleSoft did not directly distribute or install or provide technical support for EY/GEMS for PeopleSoft. It did not issue press releases, and it did not develop or test the final product. The absence of these activities indicates that EY/GEMS for PeopleSoft was not a joint product or joint business venture.

(EY Ex. 1310 at 19-20.)

⁴⁸ Consumer is "one who consumes. Individuals who purchase, use, maintain, and dispose of products and services." Black's Law Dictionary 219 (6th ed. 1991).

I disagree with EY and its experts that “in entering into the licensing agreement, E&Y was acting as a ‘consumer in the ordinary course of business’ and thus squarely covered by the exception provided in Rule 602.02.g.” (EY Ex. 1311 at 11.) Several facts cause me to conclude that EY was not a consumer and did not enter agreements similar to the Licensing Agreement in the normal course of business. A consumer is one who consumes and the definition of the verb “consume” is to do away with completely, to use up, to eat or drink, to engage fully. Merriam-Webster’s Collegiate Dictionary 248 (10th ed. 2001). EY did not consume PeopleCode or PeopleTools; rather, it used these intellectual properties and passed them on in the form of new software. For this reason, I find that EY was not a consumer in the generally accepted meaning of the term.

EY cites the fact that EY had earlier versions of EY/GEMS and to Dr. Hitt’s opinion to support its assertion that during the relevant period EY licensed software development tools to produce GEMS related software in the normal course of its business. (EY Brief at 29.) I reject this reasoning. Dr. Hitt’s citations do not support his assertion, and there is no evidence that whatever licensing was required to produce GEMS in a DOS version, a Windows version, and a client/server application involved agreements similar to the Licensing Agreement. EY’s businesses were auditing, tax, and consulting. The “bread and butter” services of EY’s tax group were tax return preparation and tax consulting. (March 21, 2003, Tr. 120-21, 139-40.)

EY licensed PeopleTools, a developmental tool, and a PeopleSoft application, PeopleSoft’s HRMS, to produce EY/GEMS for PeopleSoft. (Div. Ex. 121.) EY initiated GEMS and had developed upgrades of the program not as a major piece of its practice but as a defense measure to protect against competition and to show that EY was on the cutting edge of technology. (March 21, 2003, Tr. 139-40.) Mr. Coulson acknowledged that EY had never entered an agreement similar to the Licensing Agreement in the ordinary course of its business. This was the first time that Mr. Coulson had ever encountered a situation where the issue was whether an auditor could pay a royalty to its audit client without violating independence standards. Mr. Coulson knew of no other situation where EY made a royalty payment to an audit client. (March 26, 2003, Tr. 162.) Mr. Coulson was unaware of any other agreement: (1) making an audit client the beneficiary of an agreement the auditor entered with a third party; (2) giving an audit client veto power over what the auditor could sell; and (3) where an auditor paid a client a quarterly technical support fee during product development. (March 26, 2003, Tr. 198-01.)

The fact that some PeopleSoft employees found EY’s license of PeopleTools to EY unusual supports a finding that PeopleSoft licensed its software for product development infrequently in 1994. (March 24, 2003, Tr. 24, 167, March 28, 2003, Tr. 77, 83.) Ms. Gonzalez knew of only one other company that PeopleSoft allowed to use PeopleTools to write an application that interfaced with its HRMS/payroll. (March 24, 2003, Tr. 24.) Marsha Ann Matthews, a PeopleSoft product manager employee, was surprised when she first saw EY/GEMS for PeopleSoft in 1999 because at the time she was unaware of any products that had been built on PeopleTools. (March 24, 2003, Tr. 121, 167.) EY states that Dr. Hitt cited “numerous” examples to support his conclusion that licensing PeopleTools was a normal practice for PeopleSoft during the relevant period. (EY Brief at 30.) Dr. Hitt found three instances that PeopleSoft licensed PeopleTools to software developers who used it to produce “bolt-on”

applications that added functionality to an existing PeopleSoft application by 1993. (EY Ex. 1310 at 8.) Dr. Hitt notes that PeopleSoft licensed PeopleTools to two accounting firms by 1994, and he cited newspaper reports of two others licenses in the late 1990s. (*Id.*) It is questionable whether six licenses in a period of about ten years can be characterized as numerous. Dr. Hitt found one product that had “for PeopleSoft” in its name prior to EY/GEMS for PeopleSoft. (EY Ex. 1310 at 17-18.)

The “consumer in the normal course of business” exception originated as a narrow exception for goods or services acquired for internal use or consumption added because under the original rule “if you’re the auditor of the A&P, you couldn’t buy a loaf of bread” from an A&P grocery store. (March 27, 2003, Tr. 135-38.) In a notice of a proposed rule amendments regarding auditor independence issued in 2000, the Commission stated:

In general, an accountant acts as a “consumer in the ordinary course of business” when the accountant buys “routine” products or services on the same terms and conditions that are available to the seller’s other customers or clients. An accountant is not acting as a “consumer” if it resells the client’s products or services. Likewise, a purchase is not “in the ordinary course of business,” nor is the product “routine,” if it is significant to the firm or its employees.

Proposed Revision of the Commission’s Auditor Independence Requirements; 65 Fed. Reg. 43,148, 43,167 (July 12, 2000) in evidence as EY Ex. 1309.

EY maintains that the “consumer in the normal course of business” exception has evolved substantially since it was added to the rule in 1972. EY considers this situation similar to where the Commission found an accounting firm’s use of a client’s computer income tax data processing services for performing tax work for its clients within the “consumer in the normal course of business” exception.⁴⁹ (EY Ex. 1311 at 11, 14.) EY also cites as support the fact that the Commission has not challenged the fact that an auditor bills clients “for the costs of using another audit client’s products – such as telephone, or delivery services – so long as the terms are consistent with those available to others.” (EY Ex. 1311 at 11.)

The examples of data processing services and telephone or delivery services do not support EY’s position that EY was a consumer in the normal course of business in the arrangement between EY and PeopleSoft relative to EY/GEMS for PeopleSoft. In the computer company example, the accounting firm was one of several accounting firms using a company whose business was to run a computer program based on data supplied by the accounting firm. The accounting firm needed to have the data processed to perform the tax service it offered its clients. Using a computer processing company client to run math calculations that the auditor used in providing tax services is different in character and significance from licensing a proprietary software code and adapting it with an in-house program to produce a one-of-a-kind software containing applications of both the auditor and its client. In 1999, EY/GEMS for

⁴⁹ The Commission found that the business relationship would adversely affect the auditor’s independence if billings for the service were significant to the accounting firm, its local office that performed the audit, or to the computer firm. Codification, Section 602.02.g, Example 1.

PeopleSoft was the only expatriate management system available written using PeopleTools. (March 21, 2003, Tr. 218-19, March 24, 2003, Tr. 72.)

Another indicia that EY's relationship with PeopleSoft concerning EY/GEMS for PeopleSoft was not in the normal course of business is the level of importance each company assigned to it. The Licensing Agreement was signed by Mr. Bishko, an EY partner, national director Expatriate Services, Tax, and by PeopleSoft's general counsel. It is reasonable to assume that arrangements for computer processing services, telephone, and delivery services are not negotiated, agreed to, and signed by persons at similar high corporate levels.

I accept the reasoning of Dr. Carmichael and Mr. Rush as to why EY was not acting as a consumer in the normal course of business when it entered the Licensing Agreement. I reject Dr. Hitt's opinions because his analysis ignored the auditor-client relationship, which has implications or nuances that are not present in the technological arena. I disagree with the implications Mr. Mooney drew from the facts.

For all these reasons, I find that EY was not a consumer in the normal course of business in the direct business relationship it had with PeopleSoft relative to EY/GEMS for PeopleSoft. EY, therefore, violated Rule 2-02 of Regulation S-X because EY was not independent when it audited PeopleSoft's financial statements for fiscal years 1994 through 1999.

Did EY's Implementation Activities Violate Auditor Independence?

The second basis for the allegations in the OIP concerns EY's activities as a consultant implementing PeopleSoft software. The Division claims the implementation relationship was "fraught with potential" independence violations, and that EY's interactions with PeopleSoft in marketing and sales created a direct business relationship in violation of auditor independence. (Div. Proposed Findings at 28-32.) The Division contends that provisions of the Implementation Agreement are directly inconsistent with "actual independence and an appearance of independence between E&Y and PeopleSoft." (Div. Initial Brief at 38.) The Division cites specifically the provisions that required PeopleSoft to:

- (i) designate E&Y "as a participant in PeopleSoft's Implementation **Partner** Program";
- (ii) market E&Y's implementation services by agreeing to distribute a one-page profile of E&Y – containing information provided by E&Y – to PeopleSoft end-users; and
- (iii) permit E&Y "to attend PeopleSoft's annual user conference and to participate in its product fair."

(Div. Initial Brief at 38, Div. Reply Brief at 89) (emphasis in original.) The Division contends that additional provisions in the succeeding Implementation Agreement, which Ms. Anderson signed on behalf of EY knowing of the Commission investigation that led to this proceeding, are inconsistent with the appearance of independence. These provisions:

(i) allowed E&Y to demonstrate PeopleSoft's software products to prospective PeopleSoft customers; (ii) permitted E&Y to use PeopleSoft's Global Alliance Program logo on E&Y's marketing materials; (iii) required E&Y to maintain a minimum customer satisfaction rating and to share such ratings with PeopleSoft; (iv) obligated both parties to try to meet prior to working for a "joint Customer"; (v) obligated both parties to create a "Steering Committee" comprised of E&Y and PeopleSoft key executives to meet at least twice a year to review the status of the agreement; and (vi) required E&Y to indemnify PeopleSoft against any legal claims or judgments arising from E&Y's services to PeopleSoft's customers.

(Div. Initial Brief at 39-40, Div. Reply Brief at 90.)

The Division argues that the EY and PeopleSoft relationship as software implementer and seller, respectively, "involved extensive and intricately interwoven joint activities that created a direct business relationship," that violated auditor independence. (Div. Initial Brief at 42.) The Division maintains that, viewed in its totality, the preponderance of the evidence is that EY and PeopleSoft had a direct business relationship in which EY was not a consumer in the normal course of business, and that a mutuality or identity of interests existed that caused EY to lose the appearance of objectivity and impartiality in the performance of its audits. (Div. Reply Brief at 77.) The Division cites the following examples of behavior that created a direct business relationship between EY and PeopleSoft: (i) extensive joint coordination, including sharing confidential business information on at least three major marketing initiatives; (ii) joint targeting of specific potential clients and sharing confidential and sensitive information; (iii) mutual assistance on sales and closing deals; (iv) mutual endorsements; and (v) promoting the joint relationship for the purpose of generating mutual revenues. (Div. Initial Brief at 42; Div. Findings at 32.)

Dr. Carmichael considers that "the joint business activity of providing software implementation services to" third parties "combined with the extensive mutuality of interests in marketing and sales efforts related to these services impaired EY's audit independence." (Div. Ex. 741 at 10.) Dr. Carmichael argues that the Implementation Agreement comes within the definition, "contractual agreements to perform interdependent services for the profit of the parties to the agreement," as prohibited "joint business ventures" or "limited partnership agreements." (Div. Exs. 741 at 19-20, 129 at 031951.) Dr. Carmichael points out that the Commission's 1989 Response allowed an auditor to enter relationships, other than a direct business relationship, with a client through the use of separate contracts, but that arrangement is subject to the test of whether it created a mutuality or identity of interests which would have the auditor lose the appearance of objectivity and impartiality. (Div. Ex. 741 at 20.) Dr. Carmichael is troubled more by the "degree of connectedness" in selling than the basic implementation allowed by the Implementation Agreement. (March 28, 2003, Tr. 38, 40-41.) Dr. Carmichael concludes that considered in the aggregate, EY's implementation activities created an appearance of a mutuality and identity of interests with PeopleSoft that Section 602.02.g indicates impairs audit independence. (Div. Ex. 741 at 23.) Finally, Dr. Carmichael believes that an auditor and a client can have separate contracts with third parties; however, their interconnected activities can

create a direct business relationship between the auditor and the audit client, and that is what happened here. (March 28, 2003, Tr. 174-76.)

In forty years of accounting experience, Mr. Rush had never encountered any other audit firm or client with such a close business relationship as EY Consulting and PeopleSoft. (Div. Ex. 748 at 18.) Mr. Rush rejects EY's position that the Commission has allowed cooperative arrangements between auditors and clients, and finds that EY's implementation activities with PeopleSoft, in particular the marketing related activities created a direct business relationship that compromised EY's independence. Mr. Rush concludes that by working closely together to increase their respective revenues, EY violated the prohibition on an auditor and client "join[ing] together in a profit-seeking venture." (Div. Ex. 748 at 17.) Mr. Rush faults EY for proposals it submitted to prospective clients that boasted that PeopleSoft had positioned EY above the rest of the implementers, and Mr. Rush disagrees that reasonable investors would conclude that EY's "partner" status was as innocuous as EY claims. (Div. Ex. 748 at 10-11, 16 n.34.)

EY claims its business relationship with PeopleSoft did not cause it to lose its independence or the appearance of independence because the Commission's 1989 Response allowed auditors to provide software implementation to third parties who acquired software from an audit client, provided the implementation and acquisition were by separate contract. (EY Brief at 4.) EY cites the Commission's 1989 Response:

[T]he Commission would not raise an independence question if the party receiving the combined services contracted separately with the auditor and the audit client for their respective portions of the service engagement, thereby separating the accountant's liability and contractual obligations from those of its audit client (unless the arrangement is considered to be a material indirect business relationship).

(Div. Ex. 129 at 031949.)

EY's expert Mr. Mooney opined that, in substance, the Implementation Agreement was nothing more than an arrangement that permitted EY to hold itself out as a qualified PeopleSoft software implementer, and that "most major accounting firms were providing implementation services involving their audit clients' software and used similar arrangements." (EY Ex. 1311 at 16.) Mr. Mooney relies on language in the Commission's 1989 Response that it "would not raise an independence question if the party receiving the **combined services** contracted separately with the auditor and the audit client for their respective portions of the service engagement thereby separating the accountant's liability and contractual obligations from those of its audit client." (Id. at 16-17) (emphasis in original.) Mr. Mooney would not imply a prohibited business relationship from use of the term "partner" in the agreement, noting that neither party accepted responsibility for the actions of the other and that the Implementation Agreement states that EY is an independent contractor. (Id. at 16, 19-20.) Mr. Mooney states that the applicable test is whether or not the activities create a mutuality or identity of interest between the auditor and its client. (Id. at 18.) Mr. Mooney considers the Division's position on implementation as based largely on arguments that EY's implementation activities created an appearance that EY lacked independence. He notes there is no evidence that any informed investor, investment

analyst, reporter, or other person held this view, and he cites a report of the Gartner Group as evidence that the public understood EY's activities vis-à-vis PeopleSoft were limited because of independence considerations. (Id. at 15, 23.) Mr. Mooney understands that EY and PeopleSoft did not co-sell or jointly sell products or services, and he views the evidence as showing "nothing more than instances of mutual cooperation, or isolated occurrences." (Id. at 23.)

Dr. Hitt asserts that "a reasonable person with a modest understanding of business practices of the software industry would not conclude that there was a 'partnership' in the legal sense or a 'mutuality of interests' between EY and PeopleSoft." (EY Ex. 1310 at 3-4.) Dr. Hitt opines that the amount of interaction and extent of cooperative business relationships are substantially less than would be expected given EY's size and presence among software implementers. (Id. at 3) Dr. Hitt characterizes the business interactions between EY and PeopleSoft as normal. (Id. at 29.) Dr. Hitt asserts that EY was less aggressive and had more restive service offerings than its peer consulting firms, and that the peer consulting firms had significantly closer relationships with PeopleSoft than did EY. (Id. at 3, 27.) Dr. Hitt concluded that EY was foregoing potentially lucrative business opportunities, in part because of independence concerns.⁵⁰ (Id. at 3.) According to Dr. Hitt, there are few secrets regarding sales opportunities in the software implementing community, and it is common to share sales leads or client lists and this information provides no special advantage. (Id. at 22.)

Applying the same logic used to decide whether EY violated the independence rules in connection with EY/GEMS for PeopleSoft, the first question is whether EY engaged in a direct or a material indirect business relationship with PeopleSoft in connection with implementing PeopleSoft software, and, if so, whether in those business relationships, EY was a consumer in the normal course of business. And finally, if EY engaged in any direct or material indirect business relationships with PeopleSoft as a consumer in the normal course of business, whether its conduct created such an identity or mutuality of interests that a reasonable investor would conclude that EY would not be impartial or objective in auditing PeopleSoft's financial statements. See Codification, Section 602.02.g; Commission's 1989 Response.

The 1993 and 2000 Implementation Agreements created a direct business relationship between EY and PeopleSoft, and EY's implementation activities on behalf of third parties created a material indirect business relationship between EY and PeopleSoft.⁵¹ Unlike the EY/GEMS for PeopleSoft situation, these relationships did not per se cause EY to violate the independence rules because EY was acting as a consumer in the normal course of business. Unlike EY/GEMS for PeopleSoft, to conduct its normal business activity, EY Consulting had to enter an Implementation Agreement and deal with PeopleSoft to be able to implement PeopleSoft software. (March 27, 2003, Tr. 203-04.)

⁵⁰ Dr. Hitt appears to rely on a statement by the Gartner Group that "[b]ecause PeopleSoft is an audit client of E&Y, that precludes close partnering opportunities available to other SIs." (EY Ex. 1310 at 28.)

⁵¹ Dr. Carmichael considered the Implementation Agreement evidence of a continuing relationship for the mutual benefit of EY and PeopleSoft, but not standing alone an independence violation. (March 27, 2003, Tr. 197-98.)

Mr. Coulson stated that the Commission's staff allowed a certain level of cooperation between a vendor and a consultant so long as the cooperation "did not go too far" such that a material indirect business relationship developed that would raise independence questions. (EY Ex. 1311 at 18.) I find that EY violated the rules on auditor independence because EY's activities went "too far" and established "a continuing relationship for the mutual benefit of [the] two parties" and created such an identity or mutuality of interests between EY and PeopleSoft that a reasonable investor would believe that EY would not be objective in auditing PeopleSoft's financial statements. See Codification, Section 602.02.g.

I reject EY's defense that any violations were occasional and occurred by chance. Almost all of EY's actions detailed in the Findings of Fact regarding the implementation of PeopleSoft software were suspect and most were inappropriate for an auditor because of independence considerations. The unrefuted evidence is that Mr. Fridley and Ms. Anderson implemented a broad strategy to use the PeopleSoft sales force to the greatest degree possible to maximize sales by EY's PeopleSoft Service Line, and that EY and PeopleSoft acted together to accomplish this end, which benefited both parties. The following statement by PeopleSoft's director of corporate advertising is in sync with voluminous evidence that shows what amounted to joint sales by EY and an audit client. "Because [EY is] also a business partner of [PeopleSoft], we shared the leads that were relevant to their business and had our respective sales teams work together to contact leads generated from this marketing event." (Div. Ex. 283 at 034554.)

EY's defense that its conduct was no different than the conduct of other software implementers is also unpersuasive. Dr. Hitt's opinions and evidence that software implementers had similar business relationships with software vendors are largely irrelevant because EY was held to a different standard as PeopleSoft's auditor.

PeopleSoft's Partner Profile for EY, which was based on information EY supplied, stated that as an auditor EY must maintain an "air of independence when dealing with PeopleSoft in the marketplace," and that EY and PeopleSoft could not do joint marketing, have the PeopleSoft and EY logos appear together, refer to each other as a partner, or be in an exclusive, preferred or alliance relationship.⁵² (Div. Ex. 169.) As detailed in the Findings of Fact, EY and PeopleSoft engaged in all these actions that are inimical to an independent relationship because they cause the auditor to lose the appearance of objectivity and impartiality. Considering the types of activities and the level of activities, EY's conduct was blatant. The most outrageous were the joint marketing and joint sales activities that occurred across the board. EY agrees that the physical presence of PeopleSoft representatives at EY's sales presentation to Adventist Hospital in January 1999 was improper. I find equally improper the fact that EY and PeopleSoft salespeople held meetings in the field with respect to the Health Care Initiative and other subjects and targeted customers based on shared information; that EY and PeopleSoft regularly shared confidential, proprietary information as to customers, business plans, and sales; that EY salespersons called on and received assistance from PeopleSoft in making sales; that EY assisted

⁵² The profile explained, "E&Y is a Global Implementation Service Provider. They are not part of [PeopleSoft's] Global Consulting Alliance program, but have equal capabilities to deliver services globally to [PeopleSoft] customers." (Div. Ex. 169 at 032052.)

PeopleSoft in achieving its sales expectations; that EY used PeopleSoft logos in touting its services; and that EY asked for and received business information from PeopleSoft that was unavailable from any other source.

A software vendor and a software implementer have to interact. Where the implementer is the vendor's auditor, the auditor must be sensitive to the auditor's status and the appearance of independence. This record has no evidence that EY was sensitive or concerned about EY's appearance of independence. There is no evidence that EY's PeopleSoft Service Line ever consulted with Mr. Coulson or anyone in EY's national office on independence issues. There is no evidence that Mr. Fridley or anyone else at EY complied with the provisions of EY's PPS on Engagements in Association with Clients.

Mr. Mooney argues that investors, analysts, reporters, and publications, such as those of the Gartner Group, did not question EY's relationship with PeopleSoft and this is "compelling evidence that there was no impairment of E&Y's appearance of independence because of these matters." (EY Ex. 1311 at 23.) I disagree with Mr. Mooney for several reasons.⁵³ Most of the information in this record was not in the public domain. A great deal of evidence consists of e-mails between and among EY and PeopleSoft personnel, and internal documents of both companies. Also, even if public investors, analysts, reporters, and publications had some of this information, they did not have the total picture revealed by the evidence in this record. Also, prior to 2000, public investors and, perhaps to a lesser extent, analysts and reporters presumed that accounting firms observed applicable legal standards regarding auditor independence.

EY and PeopleSoft's activities concerning software implementations for third parties, viewed collectively, violated Rules 2-01 and 2-02 because no reasonable investor who knew all the facts - including that in both 1998 and 1999 EY earned approximately \$500,000 from auditing PeopleSoft and \$150 million from implementing PeopleSoft software - would consider EY as independent and objective when it audited PeopleSoft's financials. "[A]s the size of management advisory services fees from a particular client rises in proportion to audit fees there is a greater likelihood that independence may be impaired either in fact or in appearance." 2 Louis Loss & Joel Seligman, Securities Regulation 738 (3rd ed. 1989) (citing Scope of Services by Independent Accountants, 17 SEC Docket 877, 881 (1979)).

⁵³ On March 22, 2002, Mr. Mooney testified under oath: "I have never thought that independence rules ought to be based on appearances because that in turn always raises the question of what is perceived to be a compromise in independence by whom and the 'by whom' could reflect all kinds of different views, experiences, levels of knowledge. And I think it is an arbitrary and capricious type of standard." (April 8, 2003, Tr. 61, 67.) In the same testimony, Mr. Mooney admitted he was not aware of a general requirement with respect to the appearance of independence. (April 8, 2003, Tr. 71-72.) After reflecting on the subject, Mr. Mooney testified in this proceeding that he agreed "completely that independence in appearance is an important consideration in maintaining investor confidence in the audit process and the related financial statements." (April 8, 2003, Tr. 67-70, 78-79; EY Ex. 1311 at 14-15.)

Causation

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize sanctions by the Commission where there is a finding that a person was the cause of a violation of the Securities Act, Exchange Act, or any rule or regulation thereunder. The OIP alleges that EY caused PeopleSoft to violate Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act, and Exchange Act Rules 13a-1 and 14a-3.⁵⁴ Case law has established that causation requires findings that: (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew, or should have known, that his/her conduct would contribute to the violation. Erik W. Chan, 77 SEC Docket 851, 859-60 (Apr. 4, 2002); Valicenti Advisory Servs., Inc., 68 SEC Docket 1805, 1812 n.11 (Nov. 18, 1998), aff'd, 198 F.3d 62 (2d Cir. 1999).

PeopleSoft violated Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act, and Rules 13a-1 and 14a-3, because it filed financial statements with the Commission for fiscal years 1994 through 1999 that were not audited by an independent accountant. EY's lack of independence, within the meaning of Rule 2-01 and GAAS, caused PeopleSoft to violate Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act, and Rules 13a-1 and 14a-3. EY knew or should have known that its conduct would cause PeopleSoft to violate the reporting requirements of the securities statutes and the Commission's rules thereunder.

Did EY Engage In Improper Professional Conduct?

In 1998, the Commission amended Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 210.102(e), and provided that amended Rule 102(e) would automatically apply in all cases considered after the amendment's effective date, except for trials underway, regardless of when the conduct in question occurred. Amendment to Rule 102(e) of the Commission's Rules of Practice, 68 SEC Docket 707-08 (Oct. 19, 1998); see also Carroll A. Wallace, CPA, 80 SEC Docket 3370, 3372-73 (Aug. 20, 2003), appeal pending, No. 03-1350 (D.C. Circuit). As the result of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), 107 P.L. No. 204, 116 Stat. 745 (2002), Rule 102(e) was codified in Section 4C of the Exchange Act.

Rule 102(e) as it applies to this situation reads as follows:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter: . .

⁵⁴ Sections 7(a) and 10(a) of the Securities Act set forth the information to be disclosed in a registration statement and prospectus, respectively. Sections 13(a) and 14(a) of the Exchange Act and Rules 13a-1 and 14a-3 set forth the information to be provided by issuers of securities registered pursuant to Section 12 of the Exchange Act in periodic and other reports and in proxy solicitations.

(ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; . . .

(iv) With respect to persons licensed to practice as accountants, ‘improper professional conduct’ under Rule 102(e)(1)(ii) means:

(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or

(B) Either of the following two types of negligent conduct:

(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should have known, that heightened scrutiny is warranted.

(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

The Division claims EY is subject to a sanction pursuant to Rule 102(e) because its conduct was “at least reckless” in: (1) entering the Licensing Agreement; (2) failing to recognize that its conduct pursuant to the Implementation Agreement exceeded independence limits; and (3) failing “to adopt, implement, and maintain a thorough system of quality control policies and procedures designed to provide it with reasonable assurances” that the firm conformed with independence standards under GAAS in its audit engagements. (Div. Initial Brief at 120-21.)

The Division also asserts that: (1) a negligence standard is appropriate to assess whether EY’s actions are considered improper professional conduct; and (2) to be free from improper professional conduct as to independence, accounting firms practicing before the Commission “must adopt, implement, and maintain a thorough system of quality control policies and procedures to provide it with reasonable assurance that it is conforming to GAAS, ‘including its independence standards in its audit engagements.’” (Div. Initial Brief at 118 (citing KPMG, 74 SEC Docket at 438 n.152).) The Division claims that EY’s highly unreasonable conduct merits a sanction because EY was under an outstanding court order to comply with the same independence standards it violated. The Division alleges that EY engaged in repeated instances of unreasonable conduct by issuing audit reports for several years when it was not independent, by entering the Licensing Agreement with an audit client, and by not informing the engagement partner of the Licensing Agreement for several years. Finally, the Division claims that EY acted unreasonably by not being proactive to ensure that EY consultants were independent. (Div. Initial Brief at 121-23.)

EY maintains that it committed no violations, but even if it is found to have committed some technical independence violation, the record is devoid of evidence showing its actions, with respect to auditor independence, were knowing, reckless, or negligent within the meaning of Rule 102(e) and Section 4C of the Exchange Act. (EY Brief at 103-04.)

I find that EY engaged in improper professional conduct because it violated applicable professional standards for auditors by conduct that was both reckless and negligent.

Reckless Conduct

Recklessness has the same meaning in Rule 102(e) and Section 4C of the Exchange Act as it does under the Exchange Act's antifraud provisions. Amendment to Rule 102(e), 68 SEC Docket at 710, & nn.36, 37 (citing SEC v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992) (quoting Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 n.12 (1976)). Recklessness is defined as an "extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it." Sundstrand, 553 F.2d at 1045 (internal quotations omitted). In Wallace, the Commission held under Rule 102(e) that, "the definition of reckless conduct establishes the mental state that must be shown with respect to conduct that results in a violation of applicable professional standards . . . [t]he question is whether the accountant recklessly violated applicable professional standards." 80 SEC Docket at 3373.

The record shows that EY acted recklessly in several distinct ways. EY recklessly violated applicable professional standards by entering the Licensing Agreement with PeopleSoft and in conducting activities that violated the standards for auditor independence in connection with business relationships with an audit client. The subject of allowable business relationships between an auditor and its audit clients was a subject of much debate from the late 1980s. In 1994, EY had never entered an agreement that was similar to the Licensing Agreement. This was Mr. Coulson's first encounter with the issue of whether an auditor could pay a royalty to its audit client without violating independence standards, and he knew of no other situation where EY made a royalty payment to an audit client. (March 26, 2003, Tr. 162.) Mr. Coulson was unaware of any other agreement: (1) making an audit client the beneficiary of an agreement the auditor entered with a third party; (2) giving an audit client control over product quality; (3) where an audit client helped set the fees that its auditor charged third parties; and (4) where an auditor paid an audit client a quarterly technical support fee during product development.

Mr. Coulson conducted no independent research on the subject. Mr. Coulson did not read the proposed licensing agreement. Mr. Coulson did not consult with others at EY or at the Commission on the royalty or other issues, which were not normal in arrangements between auditors and their clients, because he considered these features standard to licensing arrangements. (March 26, 2003, Tr. 164, 195-96, 198, 200.) Mr. Coulson approved the Licensing Agreement based on two or three phone conversations of approximately twenty minutes each with Mr. Bishko. Mr. Coulson relied on an unknown person who assured him that the proposed agreement contained standard licensing provisions, and his belief that Mr. Bishko would inform him of any unusual provisions in the proposed agreement. (March 26, 2003, Tr. 157-58, 163-64.) Mr. Bishko, however, initiated the project so he had an interest in getting the Licensing Agreement approved. Mr. Coulson kept no record or notes of his conversations with Mr. Bishko and did not tell anyone at EY of the advice that he had given. (March 26, 2003, Tr. 197.)

EY's expert Mr. Mooney opined:

Considering the nature of the matter, and its size in relationship to both E&Y and PeopleSoft, Mr. Coulson made a supportable judgment based on a reasonable investigation and I believe that Mr. Coulson's decision not to look at the contract was reasonable in the circumstances. . . . I have now examined that contract and there is nothing in it that would have caused me to give advice different from that given by Mr. Coulson to Mr. Bishko.

(EY Ex. 1311 at 14.) Mr. Mooney's position is unpersuasive. The Commission has never found that an auditor, who develops a product that contains a proprietary asset of its client and markets the product bearing the client's name to persons using the client's product, is a consumer in the normal course of business. Mr. Mooney justifies EY's actions because of the "matter, and its size" in respect to the size of EY and PeopleSoft. The Commission's 1989 Response rejected the use of a materiality standard when determining auditor independence. Also, this logic would hold larger companies to a lower legal standard than smaller companies. Mr. Mooney does not define what he means by "reasonable investigation," but there is no evidence that Mr. Coulson did any investigation. Finally, Mr. Mooney is inconsistent. He finds that Mr. Coulson behaved reasonably in not reading the agreement before approving it, but Mr. Mooney found it necessary to read the Licensing Agreement before he opined on Mr. Coulson's conduct. I disagree with Mr. Coulson and Mr. Mooney. The facts support Dr. Carmichael's conclusion that "EY's conduct in entering into the agreement with PeopleSoft to develop and market EY/GEMS for PeopleSoft was an extreme and unreasonable departure from what a reasonable independent auditor would have done in these circumstances to avoid an impairment of independence." (Div. Ex. 741 at 10.)

EY also recklessly violated applicable professional standards because Mr. Frick certified that PeopleSoft's financials for fiscal years 1994 through 1999 were the subject of independent audits. Mr. Frick first saw the EY independence Guidelines when he received an e-mail from Mr. Fridley in January 1999. Mr. Frick was not an expert on independence, and he considered independence rules "somewhat vague guidelines." (March 25, 2003, Tr. 15-16, 109-10; Div. Ex. 201.) Despite these facts, Mr. Frick was the lead audit partner and his judgment was required on whether EY was independent and whether the audit was conducted in accordance with GAAS. Mr. Frick either did not know or ignored evidence that showed EY had improper business relationships with EY about EY/GEMS for PeopleSoft and software implementations. Mr. Coulson testified that a coordinating partner would know about any kind of relationship that EY had involving a Commission audit client. However, Mr. Frick did not learn that EY had a Licensing Agreement with PeopleSoft that included royalty payments until April 1999. (March 25, 2003, Tr. 91-92, March 26, 2003, Tr. 96, 113.) Mr. Frick could not exercise judgment on the Licensing Agreement or EY's various actions taken pursuant to the Licensing Agreement from October 1994 until April 1999, because he did not know about them. Mr. Coulson found it hard to imagine that a coordinating partner on an EY audit would not know of EY's interaction with the audit client. (March 26, 2003, Tr. 114.)

When he learned of the Licensing Agreement, Mr. Frick concluded that others in EY had decided that the Licensing Agreement and EY/GEMS for PeopleSoft posed no independence

issues. (March 25, 2003, Tr. 92-93, 96-97.) Mr. Frick was satisfied when Mr. Paradis learned in April 1999 that people in EY's national office had approved the Licensing Agreement, and he accepted Mr. Bishko's representation that EY Legal would review any new agreements and marketing materials even though Mr. Frick did not know what Mr. Bishko meant by new marketing materials. (March 25, 2003, Tr. 93, 138-39; Div. Ex. 234 at 032729.) Mr. Frick did not call and address any inquiries to Mr. Bishko because he considered EY/GEMS to be within Mr. Bishko's area of responsibility, and he considered Mr. Bishko knowledgeable on independence. (March 25, 2003, Tr. 139-40.) Mr. Frick did not make basic inquiries about EY/GEMS for PeopleSoft that would have revealed facts that required consideration; rather, he relied on Mr. Bishko to bring independence concerns to his attention.

Mr. Frick also knew that EY had an Implementation Agreement with PeopleSoft but he relied completely on the consulting partners, non-accountants who headed EY's PeopleSoft service line – Mr. Lindeman, Mr. Fridley, and Ms. Anderson - to bring independence issues to his attention. (March 25, 2003, Tr. 42-43, April 2, 2003, Tr. 192.) Mr. Frick's practice was to ask questions and, if he was unsatisfied, to consult with EY's experts. (March 25, 2003, Tr. 15.) Mr. Frick remembers Mr. Lindeman, and later Mr. Fridley, raising a handful of issues annually, and he recalls discussions with Mr. Coulson. (March 25, 2003, Tr. 46-47, 177.) When questioned about documents and e-mails that pertained to EY's implementation activities, Mr. Frick stated that he would have questioned many of the statements and representations concerning EY's consulting activities from an independence perspective, if he had known about them. (March 25, 2003, Tr. 59-65, 128-37; Div. Ex. 387 at 035882, 035893, 035894.) The record does not show that Mr. Frick consulted much, if at all, with Mr. Coulson or anyone in EY's national office on any of the independence issues that are the subject of this proceeding. There is also no evidence that Mr. Frick determined whether EY followed its internal procedures, PPS AA 7505, Engagements in Association with Clients, as to any of the implementation activities detailed in the Findings of Fact.

Highly Unreasonable Conduct

Rule 102(e) of the Commission's Rules of Practice and Section 4C of the Exchange Act define improper professional conduct to include "[a] single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted." According to the Commission, the "highly unreasonable" standard is

an intermediate standard, higher than ordinary negligence but lower than the traditional definition of recklessness used in cases brought under Section 10(b) of the Exchange Act and Rule 10b-5. The highly unreasonable standard is an objective standard. The conduct at issue is measured by the degree of the departure from professional standards and not the intent of the accountant. . . . conduct that poses a threat of future harm to the Commission's processes and conclusively demonstrates that the accountant lacks competence to practice before it.

Amendment to Rule 102(e), 68 SEC Docket at 710.